Chapter 2

Impact of the liberalization on the Policies of the Government of India
2.1 Post liberalization period and the liquidity resources.

Liquidity refers to how quickly and cheaply an asset can be converted into cash. Money (in the form of cash) is the most liquid asset. Assets that generally can only be sold after a long exhaustive search for a buyer are known as illiquid.

Many households, e.g. young ones, cannot borrow to consume or invest as much as they would want, but are constrained to current income by imperfect capital markets.

The Indian Liquidity story is one which has many parts; some of them are given below.

a) S&P has now upgraded India's sovereign rating to BBB. Thus all three major agencies now have given a rating of Investment Grade to India. This decision has triggered a lot of international interest - Standard Chartered global CEO said there would no longer be a ceiling/cap on Indian exposure, it would now be driven by Risk Management norms. There are already over USD 5 bn has flow into India, through banking channels. Hence the Indian rupee has already strengthened to INR 48/ USD, which represents a gain of around 2% in the year 2008. Over the next few quarters this trend is likely to become even more pronounced.

b) Domestic banks have further raised their deposit and lending rates by 50bps, in response to the statements of the RBI Governor in his quarterly review of 31st January. Now we are getting to see quotations of 10% for 1-3 year deposits. This would make banking deposits competitive with Government savings products rates of 8%. Bank deposits are growing at over 21% y-o-y, primarily from wholesale (read as Corporate/ Institutional/ Foreign) investors. The Bankex, which is an index of Banking stocks, has risen in 2007. Of course the direction is inline with the general stocks trend in India. In other words the Net Interest Margin squeeze which people were expecting has not been seen in the Dec31st quarterly results which were justdeclared.

Insurance Companies, especially the Life Insurance ones, have increased their first-premium collections by 160% in this fiscal. This is largely from the sale of Unit-linked insurance policies, and this is a reflection of the reach of the distribution network and the strong performance of the stock markets. This has been happening to the extent that IRDA, the regulatory body, has started
wondering whether this a healthy sign, as the solvency requirements for UnitLinked policies are lower than that of term/ risk policies. The 21%+ growth in bank deposits has been achieved despite the solid performance of the Insurancenetwork.

The outlook for bank liquidity is tight, but not liquidity is not scarce. Rates are expected to remain firm, and the inverted yield curve (higher short-term rates than long-term) is expected to remain in place, at least till the fiscal year end ie March 31.

c) Government Revenues have been buoyant - with about 40% growth in direct taxes. This is driven in part by the 70% y-o-y growth in the corporate profits of the Sensex Companies. The Government borrowing program has not yet shown signs of additional spending/ borrowing in following the buoyant revenues.

d) Media attention has been largely focused on the high level of asset prices - especially in real estate. Affordability concerns in the case of housing are emerging, but not at a level which is affecting the pace of offtake as yet. One reason for this could be that the growing class of entrepreneurs is also becoming more confident as they have also made good income/profits in the recent past. AIM - London Listings/ mobilisations from QIP's into Real Estate funds/ vehicles are estimated at USD 3 bn+ in 2009. As per a Business World report, this sector is expected to attract USD 15bn Institutional funds by end 2009.

The high valuations which are to be found in the stock markets are not yet attracting undesired attention due to the good corporate performance and the volume of liquidity currently flowing thru to India. India has been ranked as most promising in the update to the Goldman Sachs BRICS report update of 2007. Gold has been appreciating too, and the offtake by India, which had slowed in mid 2006, has picked up in the recent months and now it has gone to the high of 12000/- 10 grams Bullion market has seen a big jump in the year 2008.

Despite the RBI's measures to 'regulate' flows towards sensitive sectors like real-estate and capital markets, asset prices continue to show firm trends. The investment stance of individuals and corporates is strong right now, hence I guess the asset-prices are staying where they are.
The monetary policy stance has continued to be hawkish, especially as inflation is nudging above the upper band of 5.5%, towards 6%. The Government has reduced import duties on cement, and a variety of other inputs, in response to the same. So RBI is trying to do what it can to control inflation. The government has quite been successful in controlling the inflation and has brought down the inflation from 6% to 4.35% by the end of February 23, 2008. However, the liquidity which is circulating, is coming from many different directions, which is why I guess we have the inverted yield curve, and this is expected to remain so till the end of the current quarter. Of course, the forthcoming Budget can change direction and have an impact on all this.

EVEN AS India is starving for investments, especially in infrastructure, education and heath-care, there is enormous liquidity overhang in the economy. Perhaps, there is a behavioral explanation for not only India's inability to invest, but its capacity to save and acquire substantial liquid resources. A look at India's liquidity overhang and what can be done about it.

Liquidity overhang is the excess funds in the system that is not being used for consumption or investment purposes. It is idling money. At the present rates of exchange, the liquidity overhang in India is almost $70 billion. But there are certain implications of this. Some simple arithmetic first. If just half the liquidity overhang were to be invested, then Rs 150,000 crore would be available for investment. If the resources invested were to generate output equal to just their nominal value, which is a low estimate anyway, the output, valued at Rs 150,000 crore, would be generated.

Assuming a multiplier value of two, which again is a low estimate, the combined value of output would be worth Rs 300,000 crore. Not a small sum for a country the size of India — indeed, a goodly percentage of its current GDP.

That is not all. Profits and savings are important. Assuming the standard economic rate of return of 8 per cent, the profits from the output generated would amount to Rs 24,000 crore. If these were to be treated as corporate savings, they can be re-invested. If invested in social assets instead, the return would be measured in non-financial terms, but the social asset enhancement would be equally valuable.
The economic consequences, and the losses, of a liquidity overhang in India are, thus, substantial. The country is not making huge investments and is losing equally significant sums as output and profits every year. Therefore, policy-makers must address the question of the liquidity overhang in the economy.

Inflation control is often cited as a reason for creating liquidity. It is argued that releasing large sums of money into the economy would immediately drive prices up. That is, unfortunately, a pessimistic monetarist thought. It is exactly the type of thinking that made the Margaret Thatcher government starve the British economy of critical investments in the transport, health and education sectors for years, as the sanctity of M1 and the M3 was sought to be maintained and the focus was on inflation control.

The financial reality of reducing the liquidity overhang is quite different. Releasing such large sums of money into the economy as investments can raise productivity. Investment in the latest knowledge-embodied technologies is only going to raise efficiency and lower real costs. Capacity investments can only drive down costs. Therefore, inflation is not really a worry at all. But there are various sources from where the funds come. Some of them are listed below.

There are several sources for liquidity:

- The Liquidity Adjustment Facility has resources worth Rs 40,000 crore;
- The Market Stabilisation Scheme has Rs 60,000 crore.
- Surplus funds with the Life Insurance Corporation of India total Rs 100,000 crore;
- Excess funds with commercial banks add up to Rs 50,000 crore;
- Surplus funds with development finance institutions aggregate Rs 25,000 crore; and
- Funds available with the Infrastructure Development Finance Company Rs 25,000 crore.

All this total to Rs 300,000 crore. To be sure, there could be some double-counting and some over-stating. Or, there could be items not listed at all, such as the substantial sums brought in by foreign institutional investors. Unfortunately, such funds have the effect of creating asset value bubbles, first of financial assets and then of real estate that may become unsustainably high. When these bubbles burst, the results can be compellingly unwelcome.
The upshot of all these numbers is that the large amounts of money sloshing around the economy, and, yet, the economy is crying for investments. But, ironically, India does not seem to have development schemes that are worthy of funding. But there are some limits of feasibility. The sums available today within India and to India from the world's financial markets are of the stuff of a nation-builder's dream. So much can be done. A look at what Rs 300,000 crore or $70 billion, can do, if invested properly.

Some areas where the scope for investment is phenomenal:

- At least 5,000 new national highways miles can be built for Rs 10,000 crore.
- The airports of Ahmedabad, Bagdogra, Bhubaneswar, Coimbatore, Jaipur, Lucknow and Nagpur can be made world class for Rs 10,000 crore.
- At least 100 million square feet of space that can revolutionise retail sales in all the cities of India with a population of one million or more can be set up for Rs 10,000 crore.
- At least two large power stations the size of Dabhol can be set up for Rs 10,000 crore.
- Enough public toilets and sanitation facilities for the cities of Mumbai, Kolkata, Delhi and Chennai can be provided with Rs 10,000 crore.
- A mass transit system that doubles the carrying capacity of the system in metropolitan Mumbai and reduces journey time by more than half can be created with Rs 10,000 crore.
- A faculty compensation endowment fund can be created with Rs 10,000 crore that will pay at least 9,000 university faculty annual salaries that are reasonably competitive with private sector compensation rates.
- An investment of Rs 10,000 crore could lead to the acquisition of a petroleum company the size of UNOCAL that the Chinese were after, and add significantly to India's strategic energy reserves.
- An investment of Rs 10,000 crore could help diffuse broadband communications infrastructure to at least four million households in the non-metropolitan towns.
- An investment of Rs 10,000 crore could make possible the establishment of 50,000 hospital beds in India.
But there are some difficulties in investing the money. One may think that Indians may lack the way of investing. Is it that the risk aversion is so profound that they are just unable to commit resources to a long-term project?

There are some other explanations for this lack of investment. One, the continuing licence-raj mindset among the bureaucrats. After all, those who joined the bureaucracy in the late 1960s and the early 1970s are senior bureaucrats now. They grew up in the licence-raj milieu and, by 1991, had completed more than half their careers. Another reason is in the absence of the more important reforms at the local administrative levels where projects are actually implemented; entrepreneurs have become de-motivated in proceeding with their plans. In actually implementing an investment project, several operational steps are to be gone through and the role of the States governments becomes paramount. A variety of factors appears to be at work to retard investment growth in India. This is probably the best time for men of action to rise and change the face of the country. Hence I would like to quote the example of NANO Plant shifting from Singur to Gujrat. Not only for the domestic investors but also for the foreign investors.
2.2 Capital Transfers in the form FDI (Foreign Direct Investment)/FII (Foreign Institutional Investors)

As the fourth-largest economy in the world, India is undoubtedly one of the most preferred destinations for foreign direct investments (FDI); India has strength in information technology and other significant areas such as auto components, chemicals, apparels, pharmaceuticals and jewellery. India has always held promise for global investors, but its rigid FDI policies were a significant hindrance in this regard. However, as a result of a series of ambitious and positive economic reforms aimed at deregulating the economy and stimulating foreign investment, India has positioned itself as one of the front-runners of the rapidly growing Asia Pacific Region. India has a large pool of skilled managerial and technical expertise. The size of the middle-class population at 300 million exceeds the population of both the US and the EU, and represents a powerful consumer market.

India's recently liberalised FDI policy (2005) allows up to a 100% FDI stake in ventures. Industrial policy reforms have substantially reduced industrial licensing requirements, removed restrictions on expansion and facilitated easy access to foreign technology and foreign direct investment FDI. The upward moving growth curve of the real-estate sector owes some credit to a booming economy and liberalized FDI regime. In March 2005, the government amended the rules to allow 100% FDI in the construction business. This automatic route has been permitted in townships, housing, built-up infrastructure and construction development projects including housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, and city- and regional-level infrastructure.

India has been the most attractive investment destination for foreign investors. Private external inflows to India have been the highest in the last three to four years, compared to other emerging countries.

In 2004, FII investments crossed $9 billion, the highest in the history of Indian capital markets. The total net investment for the year up to December 29 stood at US$9,072 million while foreign investors pumped in about US$2,113 million in December. Korea and Taiwan have always been the biggest recipients of FII money. It was only in 2004 that India managed to receive the second
highest FII inflow at over $8.5bn. In 2005 FIIs invested more in Indian equities than in Korean or Taiwanese equities. The booming capital markets have greatly enhanced foreign investor’s interest in FCCB’s, ADR’s and GDR’s issued by Indian companies. India with inflows of $19.3 billion in 2005 was third after China and South Korea.

The average inflows for India through bonds, equities and loans during 2003-2005 has risen by 158.4% as against 40.3% for other emerging markets. The growth is largely driven by the Indian companies raising funds in the international markets.

Increasingly, corporates have been tapping the international market largely because of the interest rate differential, hedging benefits, less documentation, faster approvals, greater flexibility and greater visibility. This flow has only increased after Indian banks have been permitted to raise funds through issuance of innovative debts-perpetual debt and debt capital in foreign currency. It is expected that this pipeline will remain robust as large banks like SBI and ICICI Bank are planning to raise funds through this route shortly.

Investment is the driving force of economic growth. When investment within the country is not adequate to accelerate economic growth, foreign direct investment (FDI) has a crucial role to play. The cumulative FDI inflows since 1991 increased to $26.89 billion Rs.1,03,636 crores, while approvals were at $72.98 billion - Rs. 2,67,798 crores till August 2001. India has received foreign direct investment of US $2 to 3 billion last year while China got $40 billion in FDI. This is one of the salutary effects of liberalisation and globalisation. Apart from Delhi, major recipients of FDI had been the states of Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu. However, the flow of FDI at US $2.26 billion into India in 1998 was far lower than into countries like Singapore (U.S. $7.22 billion) China ($45.5 billion) and Mexico ($7.24 billion). While foreign investment, as a percentage of GDP was almost zero in 1990-91 and 0.1% in 1991-92, its average during 1992-2000 was 1.2%.

It is to be noted that even in 1999-2000 and 2000-01 about one percent of GDP (1.32% & 1.04%) has been the estimated share of subsidies and more than 4.6% of the GDP was the estimated expenditure on interest payments in the central governments total expenditure of
around 15.5% of GDP while total revenue expenditure was nearly 13% of the GDP. Plan expenditure, capital expenditure developmental expenditure. Expenditure on social and economic, infrastructure need to be increased significantly to achieve durable and sustainable growth.

Foreign direct investment (FDI) into India has increased significantly. The inflows are likely to be more than double the amount recorded in 2006. FDI equity inflows during April 2006 to November 2006 were $7.2 billion, which is the highest ever for equity capital since economic liberalisation. The higher inflows as well as the new credit rating reflected growing investor confidence in India. FDI inflows by the end of year 2008 had reached $12 billion. This means an unparalleled growth of 120% over years 2006-07.

The ministry of Commerce and Industry will be setting up an expert committee to look into the sectors into which FDI was flowing and its impact on the rural economy. The committee will study sectors where FDI has been allowed by the government and has a direct or indirect impact on the rural economy. Its findings would help ensure fair dispersal of FDI and thereby reductions in the rural-urban divide. Capital inflow have started to play a bigger role in determining short term currency movements than current account transactions. In May 2006, when FIIs pulled out of India in a big way, RBI could do little to control the steep depreciation of the rupee over that month. The Rupee came back on the track after FIIs returned. RBI has liberalized norms of outward flow of capital and raised the FII cap for investing in stock exchanges. This further increased the influence of capital flows on currency movements. A big plus for India is its foreign exchange reserve of over $170 billion, which can help the country manage sudden capital flight. It is argued that an estimated $70 billion should be set aside as liquidity risk, which includes about 25% of the $110 billion FII investment in equities. Infant this may not be enough in an economically and financially integrated world, where economies tend to swim or sink together. While RBI prepares itself, RBI prepares itself for freer capital flows, it should ensure that short term external debt. This is particularly important in view of RBI’s tenuous hold on exchange rates. Bond markets should be deepened in order to improve the quality and range of capital flows. This could have a salutary impact on equities and even deter investors from
seeking capital gains overseas. India’s calibrated approach to financial liberalization is regarded as a success story.
2.3 Impact of liberalization on National Income.

National Income, strictly, is a money measure of the incomes received or accruing to residents of a country as owners of the agents of production, during a specified period of time. National income includes wages, rents, interest and profits, not only in the form of cash payments, but as income from contributions made by employers to pension funds, income of the self-employed, and undistributed business profits. The trends in national income and the changes in the structure of national product are analysed over the five decades of planning.

1. Trends in NNP: The real national income of India has increased at an annual average rate of 4.4 percent during 60 years of economic planning. If we consider the last 12 years we find that the rate of increase in the national income has been around 6% per annum. Although this is an encouraging sign, when we compare this rate with the rates achieved by other developing economies like China and South Korea we find that we are still far behind in the race of economic development.

Plan wise study of growth of real income in India, however does not indicate an encouraging fact that although the annual rate of increase in national income was pretty low during the first three decades of planning, it has lately risen and stood at 5.5% per annum during the eighties and around 6.5% annum during the nineties and the highest for the year had been 12.63%.

During the first plan, annual average growth rate was 3.7% (1970-71) which increased to around 4% during the second plan. However, during the third plan, annual average increase in national income slumped down to 2.7%. This was largely the consequences of serious drought in 1965-67 and thus the growth rates got depressed. The depression continued in 1967-68. Only after 1967-68 the situation improved. During the Fourth plan the average annual rate of growth if national income was 3.4%. The sharp upsurge in prices during 1972-73 abd 1973-74 and the short falls in the production on account of lower utilization of capacity were the main factors responsible for a lower growth rate during the plan. The Fifth plan witnessed an annual economic growth rate of 5%. On the whole, the performance during the Fifth Plan was satisfactory. During 1978-79 and 1979-80, the economy suffered a set back and the national income fell by around 5.3%. India national income increased at a rate of 5.3% during the sixth plan. Again, the seventh plan period witnessed 3 years of good harvest which resulted in about 6% annual growth rate.
During the Eighth Plan, India achieved the highest ever annual average growth rate of 6.5%. The spurt in economic reforms and good harvest for almost the entire plan could mainly be responsible for such a good performance in the economy. During the Ninth Plan, the annual average growth rate dipped to 5.4%. This lower rate of growth against the target of 6.5% has been due to the dismal performance of the industry.

During the past years of the Tenth plan, the economy registered growth rates of 4.3, 8.5, 6.9 and 8.1.

There has been steady and continuous rise in supply of money in the economy since initiation of reforms. Reserve Money (Mo) has increased from Rs.99,505 crores in 1991-92 to Rs.573066 crores (Provisional) in 2005-06. Narrow money (M1) has increased from Rs.114406 crores to Rs.825245 crores (Provisional), while, broad money (M3) has increased from Rs.317049 crores to Rs.2729535 crores (Provisional) during the same period.

Net National Product (NNP) at factor cost (at 1993-94 prices) increased from 0.5 per cent in 1991-92 to 6.3 per cent in 1999-2000. It increased to 8.8 percent in 2003-04 at 1999-2000 prices. Similarly, per capita NNP increased from -1.5 per cent to 4.4 percent and then to 7.0 percent during the same period. Gross National Product (GNP) at factor cost (at 1993-94 prices) increased from 1.1 per cent in 1991-92 to 6.2 percent in 1999-2000. It increased to 8.7 percent in 2003-04 at 1999-2000 prices. Gross Domestic Product (GDP) at factor cost (at 1999-2000 prices) has increased from 4.4 percent in 2000-01 to 7.5 per cent in 2004-05.

Trends in per capita income: India’s per capita during the last 60 years of planning has increased at a rate of 2.3% per annum. This is the modest performance by all means. The rate of increase in per capita net national income product was not only conspicuously low but despite 56 years of economic planning, was still unsteady and erratic. The per capita income increased at a modest rate of about 1 percent during the first and second plans.

As the third plan witnessed severe droughts, per capita income grew at almost 0 percent. During the fourth plan the situation improved a bit bit and the per capita grew at a rate of 1 percent per annum. The performance of the economy was satisfactory during the fifth plan and the per capita income increases at a rate of 2.3% per annum. However, during 1978-79 and 1979-
80, the economy suffered a set back and per capita income fell by around 6.5% during 1979-80. The economy once again witnessed years of good harvests during the sixth and seventh plans and the per capita income recorded a growth of 3 and 4 percent per annum respectively during these plans.

It is to be noted that during the last several years the rate of increase in per capita national income is significant. It was around 4.5% per annum in the period as against 1.24% per annum during the first 32 years of economic planning.

### National Income Sector

(At Constant Prices)

(Rupees crore)

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32
Source: Central Statistical Organisation (CSO), Government of India
2.4 Capital transfers of NRI

An Indian Citizen who stays abroad for employment/carrying on business or vocation outside India or stays abroad under circumstances indicating an intention for an uncertain duration of stay abroad is a non-resident. (Persons posted in U.N. Organizations and Officials deputed abroad by Central/State Governments and Public Sector undertakings on temporary assignments are also treated as non-residents). Non–Resident foreign citizens of Indian Origin are treated on par with non-resident Indian Citizens (NRIs) for the purpose of certain facilities.

Main categories of NRIs

The following are the main three categories of NRIs:-

(i) Indian citizens who stay abroad for employment or for carrying on a business or Vocation or any other purpose in circumstances indicating an indefinite period of stay abroad.

(ii) Indian citizens working abroad on assignment with foreign government agencies like United Nations Organization (UNO), including its affiliates, International Monetary Fund (IMF), World Bank etc.

(iii) Officials of Central and State Government and Public Sector undertaking deputed abroad on temporary assignments or posted to their offices, including Indian diplomat missions, abroad.

The ambitious growth plans up to which India has embarked for mobilization of resources, include attracting NRI to invest in India. Of the total foreign direct investment approvals between 1991 and 2000 by the Foreign Investment Promotion Board and the Reserve Bank Of India, 3.86% came from NRI. Of actual flows, Which were only 36.28% of total approvals during the period, NRI contributed 9.36%. Annual Investment by NRIs was only Rs 160 crore in 1991 but jumped upto Rs 2062 crores in 1996. Since then it has been declining steadily. In the year 2000 just Rs 348 crores flew in as NRI Investment. It is estimated that NRI population over the world is around 20 million which includes professionals like doctors, engineers, consultants, management experts, industrialists, businessmen as well as skilled and semi-skilled workers. Of
these 3 million reside in USA, 1.6 million in UK, 1.4 million in South Africa, 1.2 million in Malaysia and 1 million in Canada.

NRI’s /OCBs are permitted to invest in India on repatriation as well as an on non repatriation basis. The term NRI collectively refers to NRI Nationals and persons of Indian origin. The term OCBs refers to overseas corporate bodies predominantly owned by individuals of Indian nationality or origin resident outside India and includes overseas companies, partnership firms, societies and other corporate bodies which are owned directly or indirectly, to the extent of at least 60% by individuals of Indian Nationality or origin as also overseas trusts in which at least 60% of the beneficial interest is revocably held by such persons. Normally, various facilities granted to NRIs are also available to OCBs with certain exceptions.

As a general rule, for all investments on repatriation basis, funds for the purpose of investment must be provided by proceeds of foreign exchange remittances from abroad or from the investors Non Resident External Account (NRE) Foreign Currency Non Resident (FCNR) Accounts in India. In other words the invested funds must represent free foreign exchange in the hands of investors. For investment on non repatriation basis, funds from sources stated above and balanced held in Non Resident Deposits (NRD) Accounts of the investors may be utilized. Remittance in foreign currency received in India will be converted in rupees at the ruling TTelling rate on the date of conversion.

NRIs have been provided with the many facilities for investment in India. They can invest up to 100% equity on repatriation basis in high priority industries, trading companies, hotels and tourism industries, sick industries and other industries like hospitals, and advanced diagnostic centres, shipping and export-oriented deep sea, fishing industries, oil exploration services, real estate development, infrastructural activities, power and communications and industries requiring compulsory licensing. NRI’s can invest up to 51% on repatriation, basis in new issues of new and existing companies raising capital through a public issue with prospectus.

On repatriation basis they can invest up to 100% equity in proprietary and partnership overseas, new issues of shares or debentures of Indian companies, establishing schools and colleges in India.

NRIs/OCBs are also permitted to make portfolio investment in shares / debentures (convertible or non convertible) of Indian companies with or without repatriation benefits up to 10% of the total paid up value of each series of the convertible debentures issued by the
company concerned for all NRIs and OCBs taken together both on repatriation and on repatriation basis.

Among other facilities what is noticeable is that a NRI is taxable only on the Indian income in excess of Rs 50000 pa. However, a NRI has an option to be assessed under the special provisions of Chapter X11 A of the Income tax Act or under the general provisions. Dividends received by the NRIs from the transfer of capital assets, the assets being shares and debentures of Indian companies, shall be taxable at the prescribed rates after converting the cost of acquisition, expenditure in connection with transfer and consideration received into the same foreign currency as was initially utilized in the purchase of shares or debentures. The capital gain so computed in such foreign currency shall be reconverted into Indian currency. The difference between the treatment of taxability of capital gains earned by NRIs and ordinary residents of India is that the benefit of indexed cost of acquisition shall not be available to NRIs.

However, the special procedure of using foreign exchange rate has been prescribed to protect the NRI assesses from fluctuations of rupee value against foreign currency, in order that the NRI oays tax only on the actual capital gain in foreign currency and not on the gains computed in rupees.